



CALIFORNIA INDEPENDENT OIL MARKETERS ASSOCIATION

50 Years of Industry Excellence

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MEMORANDUM

TO: Ad Hoc Integrated Energy Policy Report Committee
FROM: Jay McKeeman, Executive Vice President
California Independent Oil Marketers Association
DATE: October 22, 2002

02-IEP-1
CALIF ENERGY COMMISSION

OCT 22 2002

RECEIVED IN DOCKETS

RE: **Docket No. 02-IEP-01**

The California Independent Oil Marketers Association (CIOMA) is a non-profit, statewide association of independent wholesale and retail marketers of gasoline, diesel fuel, jet fuel, lubricating oils and other petroleum and energy products. CIOMA has approximately 450 members-including about 90% of the independent petroleum marketers in the state. CIOMA members are small, primarily family-owned businesses that supply most of the fuels, lubricants and other petroleum products that sustain California's agricultural, commercial and industrial economy. We are pleased to have the opportunity to provide these comments.

CIOMA believes that without careful coordination of both small and large businesses and state energy policy leaders there will be continuing fuel supply problems, volatile fuels markets and a reduction consumer choice and convenience.

- The conversion of California's gasoline supply from MTBE to ethanol oxygenated fuels has the potential for disaster.
- Careful planning is needed to ensure that the transition in 2006 from low-sulfur diesel to ultra-low sulfur diesel goes more smoothly than the last diesel formulation change.
- Ever-changing and increasingly expensive environmental requirements are creating a shortage of fuel refining and transportation capacity in the state.
- Those same-type requirements are threatening to eliminate low-volume retail stations in rural and inner-city locations.
- In the rush to bring cleaner burning fuels into the mix it is important to rely on good science and deliberate study so that we are not supplanting one emission for others that may be more toxic, or create adverse side-effects such as increased greenhouse emissions.
- Diversity and consumer choice must be protected to insure vigorous competition and convenience in fuel supply.

Gasoline

MTBE to Ethanol Conversion

In 2003, California will have a non-fungible gasoline supply. CIOMA believes that this will create a problem with both price and supply of gasoline.

California's gasoline supply distribution system is divided between branded and unbranded supply. Independent oil marketers deal in unbranded supply. Small independent gasoline stations depend on unbranded supply. That supply comes primarily from two California refiners. Valero and Tesoro. The remainder of the supply comes from surplus in providing

branded supply. We understand that both Valero and Teşoro have decided to wait until closer to the January 1, 2004 deadline to switch from MTBE to ethanol, while most of the branded supply refiners will convert to ethanol in early 2003.

Federal regulations prohibit the mixing of MTBE and ethanol gasoline at the retail level. State regulations prohibit mixing the two fuels when the resulting fuel violates the Reid Vapor Pressure standard. Substantial penalties can be levied if ethanol-containing fuels are mixed with MTBE-containing fuels. This condition creates a non-fungible supply of gasoline. The non-fungible fuel supply complicates logistics of delivery, especially in the independent market and unbranded fuels. Independent customers are free to order their supply from different companies. In addition, there is limited capability for our members to validate what was in the previously-ordered supply. There is a strong possibility of accidental mixing of fuels when a gasoline station is being supplied by different oil marketers, with potential for excessive fines and penalties. There will also be added expense and delay related to the need to segregate fuels and delivery.

If a refinery breaks down and is unable to make its supply, it will be difficult to replace. In the current situation, with a fungible fuel supply, refiners and suppliers can quickly overcome shortages by trades or exchanges. With a non-fungible supply, there are limited opportunities to alleviate such conditions. As we progress through 2003 it may be necessary to mix MTBE and ethanol fuels to maintain adequate supply of gasoline at the racks and at the retail/wholesale levels. An alternative mentioned will be to drain the storage tanks completely before putting the other type of fuel in. The "photo-op" of a station waiting to run dry before replacement fuel can be delivered speaks for itself. In addition this will severely complicate fuel supply logistics, with increased potential for fuel outages.

Ethanol Supply and Logistics

Getting ethanol to California presents its own set of challenges. It will require finding enough, trains, trucks and barges to ship ethanol from, primarily, the Midwest to California. Once here, storage will be needed at the ports for ethanol shipped by barge. However, storage at the port is shrinking, not expanding. It will need to be unloaded from trains and transported by truck to the terminals, since ethanol cannot go through the pipeline and most terminals do not have the capability of receiving rail shipments. Truck drivers and trucks are already in short supply. Ethanol will make the situation worse as more drivers and trucks will be needed to transport ethanol around the state. Where will these drivers and trucks come from?

Another issue is emerging – will the additional supply needed at the racks for ethanol interfere with supply of other products such as diesel? We ask the Commission to immediately look at this potential problem, and how this might affect supply to agriculture, construction, emergency services, trucking, school districts and other key diesel consumers.

Finally, the manufacture of ethanol-containing fuels will reduce fuel refining capacity by 5 – 10% (Stillwater Associates estimate). It is not clear how this reduction will be overcome, and it will certainly create a tighter fuel market in California, which is a leading reason this state's fuel prices are usually the highest in the continental US. What price is attached to the

conversion to ethanol fuels, and how does that price compare to the “environmental protection” this switch will provide?

The Energy Commission and the California Air Resources Board must work closely to plan and provide safeguards against fuel shortages, outages and extreme price swings. A much better tracking of unbranded supply is needed. In addition, better knowledge of real-time rack supplies by fuel type is critical to our members’ ability to schedule and meet their customers’ needs. Ultimately it may be necessary suspend the state’s RVP requirements to balance supply in worse-case conditions.

Constraints On Increasing Refinery Capacity And Fuel Supply

In their recent report to the Energy Commission, Stillwater Associates identified that we are getting closer and closer to our ultimate refining capacity. The implementation of more stringent fuel standards will negatively affect the efficiency of our refineries, with the net effect of reducing the State’s capability to supply its own fuel (and effect on neighboring states that have relied on California refineries for their supplies). It is well documented that California’s complicated permitting process; expensive permit conditions and open-ended litigation create a negative atmosphere for refinery expansions, modifications or ground-up proposals. This means that California will become more reliant on outside supplies of fuel and fuel components. The problem is, who is willing to take the chance on expensive refinery modifications? In addition, will there be sufficient port and inland storage to meeting this new condition? We ask the Commission to monitor this situation closely and explore policies to encourage local fuel manufacturing increases as well as increasing our capability to accept imported fuel and components.

Diesel

Ultra-Low Sulfur Diesel

In 2006, California will join the rest of the United States in converting to ultra-low sulfur diesel fuel. No fuel conversion has been without problems. The last time the Air Resources Board (ARB) lowered the sulfur content in fuel, it resulted in large-scale engine failures. While we are not suggesting that this will happen again, it is an example of an unexpected result of changing the fuel specifications. CIOMA is concerned about how the conversion will affect the supply of diesel fuel, especially unbranded supply critical to farmers, local governments, emergency services, school districts and other small-lot diesel customers.

California-Only Diesel Formula

While California will match the federal requirements for sulfur, California will continue to have its own diesel fuel standard. This California-only standard creates supply problems as it is nearly impossible to replace diesel supply when a refinery breaks down and is unable to make diesel fuel, or there is some other problem that creates a shortage. California cannot borrow diesel fuel from a neighboring state since their fuel does not meet California standards. Bringing fuel into California from a refinery that can make California diesel fuel is costly and takes time. By the time the fuel arrives, the shortage is over. The Energy

Commission should evaluate the consumer cost versus the marginal environmental benefit gained by continuing to isolate itself from outside fuel supplies.

Diesel Supply

The diesel supply is restricted by California's unique fuel standards. There is also a problem getting the fuel to where it needs to be. During the agricultural season, it is not uncommon for the Fresno rack to run out of diesel fuel. For this reason, California is working to bring extra storage capacity to the Fresno rack. Additional diesel storage and fuel reserves are a way to ensure supply, especially during peak demand.

Another issue that arises regarding ultra-low sulfur diesel (ULSD) is that it cannot be shipped in pipelines due to potential contamination. This will continue as long as current fuels contain higher sulfur amounts than ULSD. As we approach 2006, we anticipate an increasing use of ULSD, creating more complexity in supply logistics. The specter of a dual-fuel non-fungibility is one that must be considered.

We need to have a reliable policy directed at alleviating chronic shortfalls of diesel supply, and the ability to create short-term variances allowing non-California specification diesel to be used if there are "pinches" in supply.

Equipment

Stationary Equipment

Ever-changing requirements for equipment to transport fuel and dispense gasoline are another barrier to ensuring the consumer has an abundant supply of affordable fuel. Many independent gasoline stations are still paying for the underground storage tank upgrades that were required to be completed in 1998. Now, they are being required to make additional upgrades to their underground equipment by the State Water Resources Control Board ("vapor-tight" tanks and MTBE-related improvements). The ARB has also made dramatic changes to the vapor recovery equipment requirements. Unfortunately, regulatory agencies have used simple economic formulas (total cost/total units, for example) to derive the "affordability" of these requirements - if they do any calculations at all. Here is the problem in a nutshell. Our members are largely comprised of small, family-owned businesses. There is a much higher threshold of ability to comply with expensive and ongoing capital improvements. However, many times there are findings of "no significant economic impact" to small businesses when very expensive requirements are adopted.

What does this mean to the consumer? First, to the retail consumer it means less choice and loss of an aggressive element in the retail fuel supply business. It has been documented that the inclusion of independent marketers in the State's retail supply has a downward effect on prices. As our members decline, and the number of stations they operate or supply is reduced, the less choice consumers will have. And, our members typically serve stations that do not meet major oil companies' volume, location and image requirements - they serve rural, low-volume locations, inner city locations, neighborhoods and other convenient spots. So consumers are losing convenience, choice and aggressive competition, and in some areas, they are losing the only retail gasoline station available.

All of these new requirements cost money and often replace equipment that is still in good working order but does not meet current standards. What is needed is an honest, thorough economic analysis of proposed regulations, with special attention on the variable costs of compliance due to station-specific economics and break-even points. Also, agencies need to take a look at not just their requirement, but the sum-total of all business expenses to determine whether equipment upgrades and replacement is truly feasible.

Mobile Equipment

New truck engine technology is also being required to reduce diesel emissions from transportation of fuels. Plans are being developed to require retrofit of fuel delivery trucks with particle traps and NOx reduction equipment. Again, the costs to comply with these regulatory proposals are variable depending on the size of the business and the age of the equipment involved and other factors. Honest and detailed economic analysis is needed to determine regulatory feasibility.

At the same time, some industries are being pressured or required to use alternatively fueled vehicles. While we agree with the goal of reducing emissions, we believe that a more thorough analysis of the total emissions reductions that will be required from diesel trucks and a more comprehensive strategy for achieving those reductions is needed. We should eliminate piecemeal solutions that take care of one problem but create or exacerbate other emission problems.

Alternative Fuels

Alternative fuels have been and are being proposed as solutions to the emissions problems created by gasoline and diesel fuel. Barriers to the introductions of these fuels include the cost of creating a new infrastructure to deliver the fuel to the consumer, the cost of the fuels, the cost of replacing or upgrading vehicles to use the fuels, the supply of these fuels, and the acceptance of the alternatives by consumers. With these barriers to overcome, it is important that we understand what emissions problems may be created by the widespread use of these alternatives before considering them for widespread use. Replacing one toxic emission for another is not really a good tradeoff for the costs and disruptions that come from the introduction of new fuels. Replacing one toxic emission for an even more toxic emission is definitely not a good tradeoff. Another issue is whether the alternative fuels increase greenhouse gas emissions over the more energy efficient petroleum fuels.

Promoting many alternative fuels produces the same kinds of problems that having a non-fungible gasoline or diesel supply creates. It requires separate infrastructure for each kind of fuel and makes it difficult to replace fuel supply when there are disruptions in the making of that fuel. The more alternatives are available, the greater the infrastructure and supply problems.

Mergers and Consolidations

The mergers and consolidation of companies with refineries in California has shrunk the number of refineries that produce gasoline and diesel fuel for the independent market and the number of competitors at wholesale racks. This is creating a highly concentrated market, especially in regards to unbranded fuels. A few years back there were up to six unbranded suppliers. Now there are only two in the market on a daily basis. Price inversions, when the wholesale price to the independent marketer is higher than the retail price at branded retail gasoline stations, are more frequent and last longer. These price inversions are damaging to competition from independent retailers because small businesses cannot sell fuel at a loss for very long.

Another aspect of mergers and consolidations is that it has concentrated the retail market significantly to direct-delivered stations. This eliminates the independent retailer and reduces the positive effect they have on pricing, as well as eliminating consumer choice and convenience.

Finally mergers and consolidations take their toll on companies' abilities to make refinery and fuel supply improvements. The Energy Commission become much more aggressive in evaluating FTC reviews of mergers and acquisitions to insure that merged or acquired companies have the financial capability, and commitment, to increase fuel supplies in the state.

The Small Bulk Fuels Customer

Small bulk fuels customers include small businesses such as agriculture and manufacturing companies, services such as hospitals and ambulance companies and government entities such as school districts and fire departments. These customers are dependent on the independent oil marketer to bring them the fuel they need. In many cases it is not economical for larger fuel companies to service these accounts.

They are more vulnerable to price spikes because they have a limited ability to shop around, and when they need fuel, they need it immediately. It is not a purchase that can wait until the price goes down. Government entities generally have a fixed fuel budget. If the price goes beyond their budget, they have to make difficult choices. Does the school take from their lunch program to pay for diesel to supply school buses, or do they limit the school bus service they provide and strand kids who have no other way to get to school? These are the types of decisions that must be made.

We ask the Energy Commission to broaden its analysis of fuel supply to include a specific element on the small bulk fuel customer because they have unique needs and a special sensitivity to price volatility.

We appreciate the opportunity to make these comments and look forward to working with the Committee to ensure a stable and affordable fuel supply to California businesses and consumers.

Sincerely,

A handwritten signature in black ink, appearing to read "Jay McKeeman". The signature is fluid and cursive, with the first name "Jay" being more prominent.

Jay McKeeman, Executive Vice President
CIOMA

Cc: Dean Simeroth, CARB